The Insurance Company of Prince Edward Island

2002

ANNUAL REPORT

The Insurance Company
Of Prince Edward Island
People you know you can trust

Responsibility for Financial Statements

The financial statements are the responsibility of management and have been prepared in conformity with accounting principles generally accepted in Canada. In the opinion of management, the financial statements fairly reflect the financial position, results of operations and cash flows of the Insurance Company of Prince Edward Island (the Corporation) within reasonable limits of materiality.

Preparation of financial information is an integral part of management's broader responsibilities for the ongoing operations of the Corporation. Management maintains an extensive system of internal accounting controls to ensure that transactions are accurately recorded on a timely basis, are properly approved and result in reliable financial statements.

An actuary has been appointed by the Corporation to carry out a valuation of the policy liabilities and to issue a report thereon to the shareholders and regulatory authorities. The valuation is carried out in accordance with accepted actuarial practice and common Canadian insurance regulatory requirements. The policy liabilities consist of a provision for unpaid claim and adjustment expenses on the earned portion of policies and of future obligations on the unearned portion of policies. In performing this valuation, the actuary makes assumptions as to future rates of claim frequency and severity, inflation, reinsurance recoveries, expenses and other contingencies, taking into consideration the circumstances of the Corporation and the nature of the insurance policies. The actuary also makes use of management information provided by the Corporation and the work of the external auditors in verifying the data used in the valuation.

The financial statements have been examined and approved by the Board of Directors. An Audit Committee, composed of members of the Board of Directors, meets periodically with financial officers of the Corporation and the external auditors. These external auditors have free access to this Committee, without management present, to discuss the results of their audit work and their opinion on the adequacy of internal financial controls and the quality of financial reporting.

KPMG have been appointed external auditors. Their responsibility is to report to the shareholders and regulatory authorities regarding the fairness of presentation of the Corporation's financial position and results of operations as shown in the financial statements. In carrying out their audit, the external auditors also make use of the work of the actuary and his report on the policy liabilities. The Auditors' Report outlines the scope of their examination and their opinion.

Charlie Cooke
President

John Dobie
Chief Financial Officer

February 14, 2003

Actuary's Report

To the Shareholders of the Insurance Company of Prince Edward Island

I have valued the policy liabilities of the Insurance Company of Prince Edward Island for its statement of financial position at December 31, 2002 and their change in the statement of operations and retained earnings for the year then ended in accordance with accepted actuarial practice, including selection of appropriate assumptions and methods.

In my opinion the amount of policy liabilities makes appropriate provision for all policyholder obligations, and the financial statements fairly present the results of the valuation.

Jean-Luc E. Allard
Fellow, Canadian Institute of Actuaries

February 14, 2003

Auditors' Report

To the Shareholders of the Insurance Company of Prince Edward Island

We have examined the statement of financial position of the Insurance Company of Prince Edward Island as at December 31, 2002 and the statements of operations and retained earnings (deficit) and cash flows for the year then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2002 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants
Regina, Canada
February 14, 2003

Statement of Financial Position

December 31	2002	2001
	(thousands of $)	
Assets		
Cash and treasury bills (note 3)	$ 2,135	$ 2,536
Accounts receivable (notes 4 & 14)	3,860	2,906
Deferred policy acquisition costs	847	613
Unpaid claims recoverable from reinsurers (notes 6 & 7)	902	1,011
Reinsurers' share of unearned premiums (note 6)	110	84
Future income taxes	459	616
Investments (note 5)	10,105	6,883
Other assets	6	17
	$ 18,424	$ 14,666
Liabilities		
Accounts payable	$ 105	$ 105
Premium taxes payable	97	37
Future income taxes	64	112
Amounts due to reinsurers (note 6)	31	232
Provision for unpaid claims (notes 7 & 14)	8,936	7,593
Unearned reinsurance commissions	33	26
Unearned premiums (note 14)	4,785	3,332
	14,051	11,437
Shareholders' equity		
Share capital (note 10)	4,800	3,800
Retained earnings (deficit)	(427)	(571)
	4,373	3,229
	$ 18,424	$ 14,666

(see accompanying notes)

Statement of Operations and Retained Earnings (Deficit)

year ended December 31	2002	2001
	(thousands of $)	
Premiums written	$ 8,457	$ 6,176
Premiums earned (note 6)	**$ 7,204**	$ 5,944
Claims incurred (note 6)	5,256	5,957
Commissions (note 6)	961	802
Premium taxes (note 6)	273	215
Administrative expenses	722	591
Facility Association participation (note 14)	149	(12)
Total claims and expenses	**7,361**	7,553
Underwriting loss	**(157)**	(1,609)
Investment earnings (note 8)	403	581
Income (loss) before income taxes	**246**	(1,028)
Future income tax expense (recovery) (note 9)	102	(457)
Net income (loss)	**144**	(571)
Retained earnings (deficit), beginning of year	(571)	(161)
Shareholder contributed surplus allocated to retained earnings (note 15)	–	161
Retained earnings (deficit), end of year	**$ (427)**	$ (571)

(see accompanying notes)

Statement of Cash Flows

year ended December 31	2002	2001
	(thousands of $)	
Cash provided by operating activities		
Net income (loss)	$ 144	$ (571)
Non-cash items:		
Amortization	76	40
Realized gain on disposal of investments	(3)	(181)
Investment write downs	24	–
Change in non-cash operating items (note 12)	1,666	1,839
	1,907	1,127
Cash used for investing activities		
Purchases of investments	(8,118)	(4,951)
Proceeds on sale of investments	4,352	4,564
Purchases of capital assets, net of disposals	–	(5)
	(3,766)	(392)
Cash provided by financing activities		
Preferred share issuance (net)	1,000	400
Shareholder contributed surplus allocated to retained earnings	–	161
	1,000	561
Increase (decrease) in cash and cash equivalents	**(859)**	1,296
Cash and cash equivalents:		
Balance, beginning of year	2,263	967
Balance, end of year	**1,404**	2,263
Plus treasury bills greater than 91 days to maturity from acquisition date	731	273
Cash and treasury bills per statement of financial position	**$ 2,135**	$ 2,536

(see accompanying notes)

Notes to the Financial Statements

December 31, 2002

1. STATUS OF THE CORPORATION

The Insurance Company of Prince Edward Island (the Corporation) was incorporated under the laws of Prince Edward Island. The Corporation is licensed to conduct business in Prince Edward Island and New Brunswick and holds provincial insurers' licences under the *Prince Edward Island Insurance Act* and the *New Brunswick Insurance Act.*

On Jan. 1, 2001 SGI CANADA Insurance Services Ltd. (SCISL) purchased 75% of the issued and outstanding shares of the Corporation.

2. SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the Corporation are in accordance with Canadian generally accepted accounting principles. The following are considered to be significant:

Deferred policy acquisition costs

Premium taxes, commissions and certain underwriting and policy issuance costs are charged to expense over the terms of the insurance policies to which such costs relate. The method followed in determining the deferred policy acquisition costs limits the amount of the deferral to the amount recoverable from unearned premiums after giving consideration to investment income, as well as claim and adjustment expenses expected to be incurred as the premiums are earned.

Investments

Bonds are recorded at amortized cost. Treasury bills, common shares and preferred shares are recorded at cost. Dividends on common shares and preferred shares are recognized as income on their record dates. Gains and losses on the sale of investments are recognized on the date of trade. Investments are written down when there is a decline in value that is other than temporary.

Capital assets

Capital assets consist of computer hardware, software and other equipment and are recorded at cost, less accumulated amortization. Amortization is recorded on a straight-line basis, commencing in the year in which the assets are placed in service, over their estimated useful lives of three years for computer hardware and software and five years for other equipment.

Provision for unpaid claims

The provision for unpaid claims represents an estimate of the total cost of outstanding claims to the year-end date. Included in the estimate are reported claims, claims incurred but not reported and an estimate of adjustment expenses to be incurred on these claims. The provision is calculated without discounting. The estimates are necessarily subject to uncertainty and are selected from a range of possible outcomes. During the life of the claim, adjustments to the estimates are made as additional information becomes available. The change in outstanding losses plus paid losses is reported as claims incurred in the current period.

Premiums

Premiums written are taken into income over the terms of the related policies. Unearned premiums represent the portion of the policy premiums relating to the unexpired term of each policy.

Reinsurance ceded

Reinsurance premiums ceded and reinsurance recoveries on losses incurred are recorded as reductions of the respective income and expense accounts. Unpaid claims recoverable from reinsurers, reinsurers' share of unearned premiums and unearned reinsurance commissions are estimated in a manner consistent with the method used for determining the provision for unpaid claims, unearned premiums and deferred policy acquisition costs respectively.

Income taxes

The Corporation uses the asset and liability method of accounting for income taxes. Current income taxes are recognized as estimated income taxes payable for the current year. Future income tax assets and liabilities consist of temporary differences between tax and accounting bases of assets and liabilities as well as the benefit of losses available to be carried forward to future years for tax purposes that are likely to be realized. The effect on future tax assets and liabilities of a change in tax rates is recognized as income in the period that includes the date of enactment or substantive enactment. A valuation allowance is recorded against any future income tax asset if it is more likely than not that the asset will not be realized.

Cash and cash equivalents

Cash and cash equivalents in the cash flow statement consist of cash on hand and treasury bills with a maturity of 91 days or less from the date of acquisition.

3. CASH AND TREASURY BILLS

Cash and treasury bills include treasury bills and commercial paper that have an average effective interest rate of 2.8% (2001 – 2.4%) and an average remaining term to maturity of 74 days (2001 – 54 days). The Corporation's investment policy states that securities investments must meet minimum investment standards of R-1 mid, as rated by a recognized credit rating agency.

4. ACCOUNTS RECEIVABLE

Accounts receivable is comprised of the following:

	2002	2001
	(thousands of $)	
Due from insureds	$ 1,634	$ 1,192
Facility Association receivable	1,091	646
Due from broker	624	676
Due from reinsurers	383	6
Accrued investment income	104	85
Income taxes	9	290
Other	15	11
Total accounts receivable	$ 3,860	$ 2,906

5. INVESTMENTS

The carrying value and fair value of the Corporation's investments are as follows:

	2002		2001	
	(thousands of $)			
	Carrying Value	Fair Value	Carrying Value	Fair Value
Bonds and debentures	$ 9,293	$ 9,563	$ 5,978	$ 6,098
Preferred shares	608	629	678	669
Common shares	204	212	227	219
Total investments	$ 10,105	$ 10,404	$ 6,883	$ 6,986

Details of significant terms and conditions, exposures to interest rate and credit risks of investments are as follows:

(i) Bonds and debentures:

The Corporation's investment policy limits its investment concentration in any one investee or related group of investees to 5% of the market value of investment assets for corporate bonds and debentures. Also, a minimum of BBB is placed on the investment grade of bonds and debentures that may be purchased.

The carrying value and average effective interest rates are shown in the following chart by contractual maturity. Actual maturity may differ from contractual maturity because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties. The carrying values are essentially the same as the principal values and therefore the average effective rates are not materially different from the coupon rates. Interest is generally payable on a semi-annual basis.

	2002		2001	
	(thousands of $)			
Term to maturity (years)	Carrying Value	Average Effective Rates	Carrying Value	Average Effective Rates
Government of Canada:				
One or less	$ –	–	$ 51	5.4%
After one through five	3,334	4.6%	2,263	5.2%
After five	1,692	5.6%	681	5.7%
Canadian provincial and municipal:				
After one through five	1,496	6.8%	901	7.2%
After five	736	5.8%	781	6.2%
Canadian corporate:				
After one through five	1,603	5.9%	653	6.2%
After five	432	6.0%	648	6.7%
Total bonds and debentures	$ 9,293		$ 5,978	

(ii) Preferred shares:

Preferred shares have no fixed maturity dates, are generally not exposed to interest rate risk and the majority of shares held are retractable. Dividends are generally declared on an annual basis. The average effective rate is 5.3% (2001 – 5.6%).

The Corporation's investment policy limits its investment in preferred shares to issues rated Pfd-2 or higher.

(iii) Common shares:

Common shares have no fixed maturity dates and are generally not exposed to interest rate risk. Dividends are generally declared on an annual basis. The average effective rate is 3.8% (2001 – 3.7%).

The Corporation's investment policy requires Board of Director approval for its investment in common stocks and equivalent instruments of Canadian and U.S. companies.

6. UNDERWRITING POLICY AND REINSURANCE CEDED

The Corporation underwrites and reinsures contracts of insurance with SCISL and other reinsurers, which limits the liability of the Corporation to a maximum amount of $150,000 on any one loss, and $250,000 on any one catastrophe.

The following table sets out the amount by which reinsurance ceded has reduced the premiums earned, claims incurred and commissions:

	2002	2001
	(thousands of $)	
Premiums earned	$ 385	$ 328
Claims incurred	692	878
Commissions and premium taxes	48	25

7. PROVISION FOR UNPAID CLAIMS

(i) Nature and variability of unpaid claims:

The establishment of the provision for unpaid claims is based on known facts and interpretation of circumstances and is therefore a complex process influenced by a large variety of factors. Measurement of the provision is uncertain due to claims that are not reported to the Corporation at the year-end date and therefore estimates are made as to the value of these claims. As well, uncertainty exists for reported claims that have not been settled, as all the necessary information may not be available at the balance sheet date.

Factors used to estimate the provision include: the Corporation's experience with similar cases, historical trends involving claim payments, the characteristics of the class of business, claim severity and claim frequency such as those caused by natural disasters, the effect of inflation on future claims, court decisions and economic conditions. Time is also a critical factor in determining the provision, since the longer it takes to settle and pay a claim the more variable the ultimate settlement amount will be. Accordingly, short-tail claims such as property claims tend to be more reasonably predictable than long-tail claims such as liability claims.

As a result, the establishment of the provision for unpaid claims relies on a number of factors and on the judgment and opinions of a large number of individuals, which necessarily involves risk that the actual results may differ materially from the estimates.

Changes in the estimate for the provision for unpaid claims are as follows:

	2002	2001
	(thousands of $)	
Net unpaid claims – beginning of year	$ 6,582	$ 4,902
Payments made during the year relating to prior year claims	(1,930)	(2,007)
Deficiency (excess) relating to prior year estimated unpaid claims	(59)	1,164
Net unpaid claims for claims of prior years	4,593	4,059
Provision for claims occurring in the current year	3,441	2,523
Net unpaid claims – end of year	$ 8,034	$ 6,582

(ii) Type of unpaid claims:

	2002			2001		
	(thousands of $)					
	Gross	Reinsurance Recoverable	Net	Gross	Reinsurance Recoverable	Net
Auto	$ 7,794	$ 773	$ 7,021	$ 6,206	$ 584	$ 5,622
Property	294	4	290	608	303	305
Liability	848	125	723	779	124	655
Total	$ 8,936	$ 902	$ 8,034	$ 7,593	$ 1,011	$ 6,582

8. INVESTMENT EARNINGS

The components of investment earnings are as follows:

	2002	2001
	(thousands of $)	
Interest and dividends	$ 424	$ 400
Realized gain on sale of investments	3	181
Investment write down	(24)	–
Total investment earnings	$ 403	$ 581

9. INCOME TAXES

Income tax expense differs from the amount that would be computed by applying the federal and provincial statutory income tax rates to income before income taxes. The reasons for the differences are as follows:

	2002	2001
	(thousands of $)	
Net income (loss) before income taxes	$ 246	$ (1,028)
Combined federal and provincial tax rate	42.1%	44.1%
Computed tax expense based on combined rate	$ 104	$ (454)
Increase (decrease) resulting from:		
Non-taxable portion of investment income	(18)	(25)
Other	16	22
Total income tax expense	$ 102	$ (457)

10. SHARE CAPITAL

Authorized:

- 30,000,000 common shares, with no par value.
- 6,000 class A, series 1 preferred shares with a par value of $100 per share, cumulative dividend paid as determined by the Board of Directors at a rate equal to the five-year Government of Canada bond rate plus 1% per annum adjusted pro rata if redemption takes place prior to the annual anniversary date of issuance. The company may redeem the shares in whole or part at any time for $100 per share.
- 10,000 class A, series 2 preferred shares with a par value of $100 per share, cumulative dividend paid as determined by the Board of Directors at a rate equal to the five-year Government of Canada bond rate plus 1% per annum adjusted pro rata if redemption takes place prior to the annual anniversary date of issuance. The company may redeem the shares in whole or part at any time for $100 per share.
- 2,484,000 class A, series 3 preferred shares with a par value of $100 per share, no set dividend rate, retraction or redemption rights.
- 5,000 class B, series 2 preferred shares with a par value of $100 per share, no set dividend rate, retraction or redemption rights.
- 2,495,000 class B, preferred shares with a par value of $100 per share, no set dividend rate, retraction or redemption rights.

	2002	2001
	(thousands of $)	
Issued and fully paid:		
3,000,000 common shares	$ 3,000	$ 3,000
4,000 Class A preferred shares, series 1	400	400
10,000 Class A preferred shares, series 2	1,000	–
4,000 Class B preferred shares, series 2	400	400
Total share capital	$ 4,800	$ 3,800
Share redemptions during the year:		
Number of shares		
Class B preferred shares, series 1	–	4,000
Value of shares (000's)		
Class B preferred shares, series 1	$ –	$ 400
Shares issued during the year:		
Number of shares		
Class A preferred shares, series 1	–	4,000
Class A preferred shares, series 2	10,000	–
Class B preferred shares, series 2	–	4,000
Value of shares (000's)		
Class A preferred shares, series 1	$ –	$ 400
Class A preferred shares, series 2	1,000	–
Class B preferred shares, series 2	–	400

The class A preferred shares, series 1, have cumulative dividends in arrears of $22,400 at the end of 2002.

11. FAIR VALUE

The following method and assumptions were used to estimate the fair value of each class of financial instrument:

(i) For the following financial instruments the carrying amounts approximate fair value due to the immediate or short-term nature of these financial instruments:

(a) cash and treasury bills
(b) accounts receivable
(c) accounts payable
(d) premium taxes payable
(e) amounts due to reinsurers

(ii) For the following financial instruments the fair values are considered to approximate quoted market values on recognized stock exchanges, based on the latest bid prices.

(a) bonds and debentures
(b) preferred shares
(c) common shares

(iii) Provision for unpaid claims and unpaid claims recoverable from reinsurers.

The fair value of the provision for unpaid claims and unpaid claims recoverable from reinsurers has been omitted because it is not practicable to determine fair value with sufficient reliability (note 7).

12. CASH FLOWS

The change in non-cash operating items is comprised of the following:

	2002	2001
	(thousands of $)	
Change in non-cash operating items:		
Accounts receivable	$ (954)	$ 151
Deferred policy acquisition costs	(234)	(112)
Unpaid claims recoverable from reinsurers	109	(739)
Reinsurers' share of unearned premiums	(26)	(82)
Future income taxes	109	(457)
Accounts payable	–	6
Premium taxes payable	60	11
Amounts due to reinsurers	(201)	228
Provision for unpaid claims	1,343	2,419
Unearned reinsurance commissions	7	24
Unearned premiums	1,453	390
	$ 1,666	$ 1,839

13. RELATED PARTY TRANSACTIONS

Included in these financial statements are transactions with various Saskatchewan Crown corporations, departments, agencies, boards and commissions related to the Corporation by virtue of common control by the Government of Saskatchewan and non-Crown corporations and enterprises subject to joint control and significant influence by the Government of Saskatchewan (collectively referred to as "related parties"). Transactions and amounts outstanding at year-end are as follows:

Category	2002	2001
	(thousands of $)	
Investments	$ 331	$ –
Accounts receivable	1	–
Investment earnings	6	–

The direct premiums are written by companies affiliated with the minority shareholder with a receivable at the end of the year of $624,000 (2001 - $676,000), direct premiums written of $9,981,000 (2001 - $7,228,000) and commissions paid of $1,056,000 (2001 - $862,000). The minority shareholder is a member of the Corporation's senior management. The Corporation incurred $360,000 (2001 - $301,000) in claim adjusting fees from a company related to the minority shareholder. The policies written by the related party and the adjusting fees paid to the related party are in the normal course of business. A company related to the minority shareholder provides premium financing for policyholders. In 2002, premiums financed were $3,363,000 (2001 - $2,512,000).

At the end of the year, the amounts due to or from the affiliated companies (note 4) include the transactions referred to above and are payable or receivable in accordance with the relevant agreements, generally on an annual basis.

SCISL provides management and administrative services to the Corporation as well as being the reinsurer (note 6). Administrative expenses charged to the Corporation were $75,000 (2001 - $75,000) and accounts payable are $1,600 (2001 - $1,100).

14. FACILITY ASSOCIATION

The Corporation is a participant in various risk sharing pools whereby most companies in the industry share resources to provide insurance for high risks.

Facility Association transactions recorded in the Corporation's financial results are as follows:

	2002	2001
	(thousands of $)	
Premiums written	$ 1,118	$ 642
Premiums earned	$ 943	$ 567
Claims incurred	872	429
Commissions	181	103
Premium taxes	39	23
Total claims and expenses	1,092	555
Net income (loss)	$ (149)	$ 12
Facility Association receivable	$ 1,091	$ 646
Unearned premiums	258	83
Provision for unpaid claims	967	531

15. SHAREHOLDER CONTRIBUTIONS

In 2001 the previous shareholder and minority shareholder contributed $161,000 to fund the negative retained earnings at the end of 2000. This contribution has been offset against retained earnings in 2001.

16. COMPARATIVE FINANCIAL INFORMATION

For comparative purposes, certain 2001 balances have been reclassified to conform to 2002 financial statement presentation.